

Exclusive risks, exclusive rewards

► KEY RISK DATA

There's no doubt that exclusives can add value, but the true value can only be gauged at the end of the exclusive period – something which lenders rarely measure. By *Eugene Picone* and *Paul Wilson*, senior vice presidents at JPMorgan Securities Lending.

THE SECURITIES lending industry has recently seen a slight resurgence in the use of exclusive securities lending arrangements. These structures have been around for a long time and were all the rage in the late nineties, but today they are much less prevalent. But what is the reality behind these arrangements? What does the risk reward profile look like? Are they the win/win scenario they are often painted to be, or in reality is it something different?

The Exclusive

An exclusive is an arrangement under which in return for a pre-determined fee or price, a lender (beneficial owner) agrees to make available for borrowing on an exclusive basis, its portfolio or a portion of its portfolio to a particular borrower. Many exclusives are established by way of an auction, through which the lender, either directly or via a duly appointed agent, such as JPMorgan, requests bids from a variety of different borrowers. The lender will decide which borrower(s) will be awarded the exclusive (which may be for the entire portfolio, or for a particular market, security type or geographic region) based on the bid(s) that most closely match the lender's requirements. Exclusives are generally awarded to the highest bidder(s), with little consideration given to other factors.

Given borrower demand, exclusives are most commonly established for equity, rather than fixed income, portfolios. There are several reasons for this. First there are a relatively small number of securities that

virtually all borrowers want to borrow (typically large emerging market benchmark issues, certain distressed securities or the cheapest to deliver bonds in the futures baskets). It is therefore not economic for borrowers to bid for an entire fixed income portfolio, since they will not want to borrow many of the securities in that portfolio. A second reason is balance sheet usage. An average fixed income loan is substantially larger than the average equity loan, but the spread is much lower. To commit to the large balances that would be necessary for a fixed income exclusive to be acceptable to a lender, would typically not be an efficient use of balance sheet for most borrowers. Borrowers like the flexibility of being able to unwind positions over month and/or year-end, if needed.

Advantages

To a lender, the advantages are typically that the lender is able to extract a premium in revenue terms from a borrower who is willing to pay more than the intrinsic value of the portfolio, given that a borrower is obtaining a guaranteed supply. Lenders often believe an exclusive gives rise to transparency since, with several parties bidding simultaneously for the portfolio, direct comparisons can be made. As lenders will often receive the fee by way of either a fixed pre-agreed amount or a basis point fee, earnings typically are a lot more predictable.

For borrowers, the main advantage is a guaranteed supply of attractive securities, which is an important selling criterion for their prime brokerage business. Borrowers can directly target the specific securities and portfolios from which they want to borrow, without the need to borrow expensive general collateral. An abundant amount of attractive securities in key markets can equate to higher revenue. Further, bor-

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rowers benefit significantly from any specials arising during the term of the exclusive, as this would not have been priced (specifically) into the bid.

Risks

On the face of it, the exclusive arrangement seems to be a win/win for the lender, the borrower and the lender's agent. But is it? It is generally accepted that there is no increased reward without increased risk, so what are the increased risks for the lender associated with an exclusive?

- **Concentration risk.** A natural consequence of an exclusive is that counterparty risk is increased considerably, especially where one borrower has access to the entire portfolio. The question a lender needs to ask is whether this lack of diversification is prudent risk management. This risk can, of course be managed somewhat (although not eliminated), as the lender does choose the borrower; and the borrower still needs to lodge collateral at a margin above the value of securities borrowed. Borrowers must ensure that they have the capacity, in terms of regulatory capital, to borrow to the levels needed to generate earnings greater than those committed to the lender.

- **Increased volumes.** This risk arises as a consequence of paying the exclusive premium, meaning that borrowers will try to work the portfolio very hard in order to generate a high level of profitability. From JPMorgan's experience of exclusives, loan balances tend to be at least double and in some cases triple 'normal' levels, with transactions (loan and collateral movements) tending to be at least five times those clients would see in a custodial/ actively managed lending program. So, what are the principal consequences?

Where recalls have to be issued, the lender is likely to see a greater number of failed trades, as swaps are not possible as the lender has entered into a direct relationship with the borrower and is not part of a larger lending program. With such high volumes, it is prudent to manage the loan volume in an automated way, via such systems as EquiLend and to also place some limit on the volume and number of collateral switches. One should bear in mind, however, the general rule that the greater the number of restrictions, the lower the fee that a borrower will be willing to pay. It should also be noted that higher volumes create much higher costs, costs being a critical component of the lending business ignored or forgotten by many.

Another consequence is that balance volumes will be higher and, as a consequence, while the increased revenue should result in an overall increase in the return on the portfolio, the return on the on-loan balances, however, typically goes down. The chart below illustrates this phenomenon.

The lender therefore needs to look beyond the headline revenue number and assess whether this represents good value on a risk-adjusted basis. In the chart example, the lender is actually earning 30% less relative to its on-loan balances.

- **Fair value.** There is no doubt that when the exclusive is struck, especially in the manner already outlined, the lender is able to compare directly different offers and accept the one it deems to be most advantageous. "In arriving at their offers, borrowers use a wide range of assumptions about the dynamics of the portfolio and market events that may arise during the duration of the exclusive," says Michelle Phillips, global head of trading at JPMorgan. "Unusual events are not generally factored in, and the borrower will typically hope that a number of the securities become 'special', as this will be to the borrower's advantage." The lender cannot really complain if this happens, as at the outset it has received the premium for the exclusive. However, what lenders seldom, if ever, do is look back after the exclusive is over, and consider factors that affected the intrinsic value of the individual securities in the portfolio, and assess whether the fee paid by the borrower for the exclusive rights represented the true value. In other words, in hindsight, the lender may have made or lost money as a result of the exclusive, relative to having lent the portfolio on an active basis without exclusivity.

- **Cash Collateral Risk.** "One much overlooked area of potential risk associated with exclusives is in respect to cash collateral," says Jim Wilson, chief investment officer for cash collateral at JPMorgan. "While in an actively managed program, the management of cash collateral is generally regarded as one of the higher risk areas, there is sometimes not the same level of focus on it in an exclusive arrangement." Indeed, from an actual re-investment perspective, the guidelines under which cash is managed remain the same as in an actively managed program, as directed by the lender. There can be increased risk, however, for several reasons. First, generally speaking, in an actively managed program, lending and cash re-investment are usually carried out by the same agent. Under this scenario, where the same organisation is responsible for both the asset and liability sides of the transaction, due consideration is given to both. Second, the lending agent often has a great deal of control over the cash collateral balances in an actively managed program and can manage the overall lending book so that, from day to day, significant swings in balances are minimised. Under an exclusive arrangement, however, on any given day the borrower will want to post the least expensive, most readily available form of collateral. In fact, it is not unusual for there to be dramatic swings in the type and size of collateral provided from day to day. This can be at odds with the lender's cash reinvestment strategy that often assumes a more long-term investment outlook than just overnight. So, while first and foremost the key objective of prudent cash reinvestment is principal protection, and second to generate a sufficient return to meet the pre-agreed rebate rate with the borrower, the lender often has an expectation that the cash re-investment program will generate an additional level of revenue. If significant swings occur in balances, cash has to be managed on a much shorter-term basis, which can affect the return achieved.

So how can this situation be managed? At the time of agreeing to the exclusive, the lender should ensure that agreements are made concerning cash collateral and rebates. This may entail agreeing that: (a) the

BALANCE VOLUMES

	Non Exclusive Program	Exclusive Program
Portfolio Value	1,000,000,000	1,000,000,000
On Loan Balance	250,000,000	500,000,000
Revenue	1,500,000	2,000,000
Return to Portfolio (bps)	15	20
Return to on Loan (bps)	60	40
Source: JPMorgan		


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rebate rate will be at a slight discount to the benchmark rate, (b) a minimum level of cash that will be maintained, regardless of outstanding loan levels, and (c) there will be a maximum amount of cash that can be withdrawn by the borrower on any given day.

● **Regulatory Risk.** In addition to material change clauses, usually covering significant shifts in the form or size of the lender's portfolio, regulatory or tax changes have the potential to impact an exclusive arrangement. The borrower makes a number of assumptions regarding the lender, its tax status and the outlook over the term of the exclusive. It is possible, and with the vast amount of potential regulatory change being considered in Europe at present (European Court of Justice Most Favored Nation tax treatment, and the German Investment Tax Act, to name but two), what was envisaged at the outset, may not be the case throughout the full exclusive period. While the borrower will often be substantially protected from adverse changes, as contracts may provide for fee renegotiation where such changes occur or for a reduced fee, the lender may well be exposed. Specifically, there may be exposure if a change is material and earnings have to be repaid to the borrower, or if a retrospective tax change is implemented (as has happened in France) and a higher level of tax refund could have been obtained if the securities had not been on loan, which obviously is unlikely to be obtainable on manufactured income payments.

Support for our clients

For an agent lender such as JPMorgan, supporting exclusives is an integral part of our commitment to our lenders. Where customers have shown an interest, JPMorgan has been prepared to support that decision. A good example of this is in new markets. JPMorgan has built a reputation of being innovative and first to market with new opportunities, as evidenced by being the first agent lender into the Korean market. As the early pioneer, our view was that, as other lenders eventually accessed the market, spreads and revenues would fall. We therefore concluded, and were proved correct, that, where our lending clients expressed interest, arranging and agreeing exclusives on their behalf with a number of borrowers would offer the maximum return. Elsewhere, we support on behalf of clients some of the largest exclusives in the industry, providing seamless integration with clients' main investment activity, organising the initial exclusives "auction", holding collateral, marking to market, delivering and receiving securities, and providing reporting to the lender.

So, do exclusives create more risk and does the potential increased revenue compensate adequately for the increased risk? There is no doubt that exclusives, executed under the right terms and conditions can add value, but the true value can only be gauged at the end of the exclusive. It is important that exclusives are entered where there is the right level of trust, understanding and most of all relationship between borrower, lender and lender's agent. When choosing an exclusive partner, a lender should just not automatically choose the one making the highest bid, but one with whom it can have a trusting and prosperous relationship. 

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